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Research paper

Experiences of global Islamic microfinance practices: lessons learnt and way forward

Salina Kassim[1]*, Siti Nadhirah Kassim[2], Nadhrah Othman[3]

[1]*International Islamic University Malaysia*
[2]*International Islamic University Malaysia*
[3]*International Islamic University Malaysia*
**Corresponding author E-mail: ksalina@iium.edu.my*

Abstract

Despite the increasing need for microfinance services that are shariah-compliant among the Muslims, growth of the Islamic microfinance industry has not been as encouraging as that of the conventional counterpart. Islamic microfinance accounts for a mere 0.5% of global microfinance, amid the absence of a cost-efficient service model. As a result, financial inclusion rate in most Muslim countries stands at only 27%, with religious requirement being quoted as one of the important obstacles. This study intends to evaluate the current practices of several leading Islamic microfinance institutions globally and learn from their experiences and best practices in efforts to further improve the Islamic microfinance industry in the future.

Keywords: *Microfinance; Islamic Finance; Global.*

1. Introduction

Microfinance has been in existence for quite a while yet significant initiative to formalize the provision of financial services to the poorest socio-economic group was not taken until the early to mid-1980s. It has since then started expanding all over the globe. Presently, there are thousands of microfinance institutions (MFIs) offering financial services to poor people with entrepreneurial abilities to help improve their economic and financial conditions. MFIs typically have the objective of overcoming poverty by providing loans to poor or low-income clients.

In the Muslim countries, despite the need for shariah-compliant microfinance services, growth of the industry has not been as encouraging as the conventional microfinance. Zulkhibri (2016) documented that Islamic microfinance accounts for a mere 0.5% of global microfinance, amid the absence of a cost-efficient service model. Consequently, the financial inclusion rate in most Muslim countries stands at only 27%, with cost, distance, documentation, trust, and religious requirements are among the important obstacles. Naceur, Barajas, & Massara (2015) also highlighted that while physical access to financial services has increased in the Muslim countries, usage rate of these services have been lackluster. Alarmingly, 72% of the population living in Muslim majority countries refrain from taking traditional financial services in view of the impermissibility of some conventional products with regards to its compliance to Islamic principles (Honohan, 2007). Some MFIs have addressed this issue by fulfilling the demand for financial products that are compliant with Islamic principles thus contributing to the emergence of Islamic microfinance as a new market segment. Islamic microfinance can be regarded as the convergence of microfinance and Islamic finance. It has the potential to merge the principle highly valued in Islam of helping the less fortunate with that of microfinance's ability to provide financial access to the poor. This could allow for financial access to the large number of poor Muslims currently refusing to utilize the Islamically incompliant microfinance products. However, Islamic microfinance is still in its nascent stage with business models that are just emerging.

This paper fills the gap in the literature by evaluating current practices of several leading Islamic MFIs globally so as to learn from their experiences to further improve the Islamic microfinance industry. By adopting a case study methodology, the study analyses the mechanisms and best practices of selected Islamic microfinance models currently operating in the Muslim world.

2. Business models of Islamic MFIS

Akhuwwat Model, Pakistan. Islamic microfinance in Pakistan makes up merely 0.5% of the microfinance sector eventhough 90% of its population are Muslim, thus making it one of the most promising markets (Karim, Tarazi, & Reille, 2008). The first model is Akhuwat, which was established in 2001 to provide Shariah compliant microfinance products in achieving economic growth. The operation is mainly focused in urban areas like Punjab even though it has branches in rural areas namely KPK and Baluchistan but with lower presence (Kazim & Haider, 2012). Over the past decade, a microfinance model with particular characteristics has been successfully designed to meet its objectives. The main financial product adopted by Akhuwat is Qard-Hasan i.e. interest free loans to their clients with flexible grace periods. Akhuwat offers loans based on an individual basis and not on a group lending system (Kazim & Haider, 2012).

Although the organization has managed to attain a funding base of its own, it still relies on donations to help cover the costs. As its name suggests, the model is developed on the concept of community. There is social collateral present in this model as many of Akhuwat's offices are established in communities where the community guarantee its member. As a tool to mitigate its risk in default, most branches have been established in sacred places visited frequently by the residents like mosques and churches. Loans are granted on the basis of brotherhood with the community acting as a guarantor for all its members. By cultivating trust in both the MFIs and borrowers, this model has been well- accepted by society due to its simplicity and the absence of interest element.

Wasil Foundation, Pakistan. Wasil Foundation is formerly known as Centre for Women Co-Operative Development. Prior to being registered as a company in 2012, it was established as a Non-Governmental Organization (NGO) in 1992. Since its establishment, this organization has been committed to reduce poverty through enterprise creation and the development of value chain programs to its clients. The primary objective of the organization is to equip the poor with knowledge and facilitate them in developing their businesses through Microcredit and Enterprise Development Programs (Wasil Foundation, 2017). Wasil Foundation has become the precedent organization in Islamic microfinance sector in Pakistan because it has gradually transformed its operation to becoming a fully Islamic MFI in 2010. It has successfully established five financial products under the label of Islamic microfinance namely Salam, Murabaha, Ijara, Istisna, and Diminishing Musharakah to be in line with Islamic law. By adopting CPB (Cost Per Borrower) and OEA (Operating Expenses to Assets), a research conducted in 2014 revealed that Islamic MFIs were more cost effective than conventional MFIs. To illustrate its potential, in a Islamic Microfinance Challenge held in 2014 with a theme of "Beyond Murabaha", Wasil Foundation managed to take home the prize of $100 000. This particular theme is specifically chosen as an alternative to encourage Islamic financial institutions' key industrial players to come out with fresh ideas as financial solutions instead of adopting the usual "cost-plus-markup" concept. To ensure the most optimal return in its financing, a very well thought out techniques are employed by the organisation.

Jabal al-Hoss Microfinance, Syria. The Jabal al-Hoss microfinance program in Syria is based on the village banking model of the Foundation for International Community Assistance (FINCA). The FINCA model was first introduced in 1980s in Bolivia and adopts a village banking model to redress poverty by creating financially sustainable groups. Small community groups are trained by FINCA in a 22-module program with the aim of establishing Community Credit of Enterprise (CCE) that enable members to generate capital in setting up their own business models by way of shares purchase (Fotabong, 2011). In this model, a supporting agency i.e. the local headquarters of FINCA sets up individual village banks comprised of thirty to sixty members whom are mostly women to receive financing. At the initial stage of their establishment, the supporting agency supervises the village banks (Fotabong, 2011). The weekly repayments of individual financing are made over the course of four-month period in equal installments of principal and interest. Upon the completion of repayment from the clients at the village banks level, the village banks are able to repay the entire loan principal with interest to the supporting agency (Obaidullah & Khan, 2008). "External" capitals for financing to individual members are thus created by the circulation of funds between the supporting agency and the village bank. To illustrate, if the village bank repays the loan in full amount, it is entitled to get a second financing. Conversely, if the village bank is unable to pay the amount due, the supporting agency will not inject further credit until reimbursement is made. Peer pressure plays a vital role in maintaining full repayment, thus assuring further injections of capital and also instigate savings. Savings accumulated in a village bank is also used for financing.

Al-Amal Microfinance Bank (AMB), Yemen. AMB was established in 2009 and recognised as the pioneer in microfinance banking sector in the Middle East under the scrutiny of Yemeni Law. AMB is a non-profit organization that provides financial services to the underprivileged households in Yemen especially small entrepreneurs. It offers various financial services namely credit, saving, insurance, transfers welfare loans and many others (Al-Amal Microfinance Bank Annual Report, 2015). To fulfil its objective of enhancing the economic and social conditions of its citizen, there are various types of financial products and services offered which include individual loans that are divided into two sub categories namely Alamal Individual and Sharakat e.g. group loans, saving, deposits and transfer. For instance, Alamal individual loan is developed to assist individuals running small enterprises regardless of gender. The intended clients of this type of financing are individuals with income-generating activities. The loan disbursement amount ranges between 30,000 – 1,000,000 YER with a grace period of 6 to 24 months. An example of risk mitigation techniques employed by AMB is a thorough screening process which require the applicant to be of Yemeni nationality and skilful in managing the project. In addition, commercial collateral is required in exchange of financing. Group loans known as Al Amal Solidarity Group on the other hand is implemented based on the concept of group lending to clients from similar income group residing in the same locality where each member vouch for one another. This product seeks to help those with income generating business with insufficient guarantees. The loan ceiling of this kind of financing is between 10,000 – 200,000 YER with a grace period of 6 to 24 months. A similar risk mitigation technique is employed but commercial collateral is not required for this type of financing because each member guarantees one another.

Rural Development Scheme (RDS), Bangladesh. Islami Bank Bangladesh Limited (IBBL) was established in 1983 as a public company under the purview of the Company Act 1913. It has become one of the nation's leading banking institutions. RDS has been introduced in 1995 to meet the market demands of the agricultural and rural sector to create employment opportunity in the short term and to raise income level of the rural people in the long run. RDS is the specialized form of banking scheme of IBBL, provided for those living under the poverty level. Through RDS, IBBL promotes Education Program, Capacity Building Program and Humanitarian Assistance Program. A few studies have indicated that household income and expenditure of the RDS clients have increased substantially thus improving their standard of living (Mizanur Rahman, Jafrullah, Tawhidul Islam, 2008).

RDS has helped to develop rural area through different welfare programs. For example, the awareness on the significance of micro savings inculcated by RDS to its clients has motivated the clients to invest their money. As a result, people are involved in micro investment schemes that combine both saving and investment. Clients may choose from available investment modes such as trading, service, processing-manufacturing and others. RDS also contributes to the rural development through deposit mobilisation and investment allocation. In a research by Shohrowardhy & Alauddin (2015), the average trend of RDS deposit per annum and investment is recorded to be 1494.00 million BDT. This has shown that investment amount is three times bigger than deposit but remarkably, the average recovery rate of investment is observed to be 99%. RDS is indeed essential in the development of rural and urban economy of Bangladesh.

Building Resources Across Communities (BRAC), Bangladesh. BRAC was established in 1972 after the country's independence by Sir Fazle Hasan Abed as a small-scale rehabilitation and relief organization. It is largely self-funded through a series of social businesses such as chain of retail handicraft establishments as well as food and dairy projects. BRAC began to offer microcredit in 1974 with its activities revolving around savings and credit operations, collecting the former and distributing the latter. For the management of savings and credit operations, it adopted the village organisation concept where group members are pressured to attend meetings and repay instalments on a weekly basis. Peer pressure is also applied in saving and borrowing cash. BRAC follows the structure of a banking system as it believes that interest should be paid on savings and the source of loans should be funded by interest paid from loan borrowings. The income from interest has to be adequate to cover operational expenses as well as the financial reserve cost of maintenance thus spread between loans and savings is essential to its banking policy (Mannan, 2009). The precondition to receiving loan is saving. Up until 2006, there were restrictions on withdrawal of savings but after seeing the positive effect of a less strict approach to withdrawal in terms of fund mobilization, members were allowed to withdraw their savings.

Majority of borrowers are not able to pay back since borrowers are those who need loan for consumption of bare necessities rather than investment activities. As a measure to address this increased risk of default, BRAC ventures into income generating projects to provide safe participation of the poor leading to credit viability. These projects for investments create an internal market through which the female group members could engage in economic activities. The strategies adopted by BRAC are its dependency on donations as an NGO, profit generated from business enterprises as well as income through the control of labor in internal market. BRAC gradually transformed from donor-financed microcredit to a market-financed microcredit based on an economic model (Mannan, 2009). Although in its core the objective is to reduce the level of poverty, it is constantly looking for alternative channels in the business segment for continuous funding and to ensure financial stability.

Al-Amana, Morocco. Al Amana is the leading MFI in Morocco with the largest number of active borrowers in Morocco (Mcphee & St-Onge, 2009). The establishment of Al Amana started in 1997 with the financial assistance of United States Agency for International Development (USAID) at the amount of $10.5 million. The technical assistance from USAID coupled with suitable infrastructure allowed Al Amana to rapidly grow and develop into a large institution (Mcphee & St-Onge, 2009). The objective of Al Amana is to encourage microenterprises by allowing access to credit for commercial microentrepreneurs who could not obtain financial inclusion. Al Amana started from urban areas and extended to semi-urban area and subsequently rural areas (Crépon et al., 2011).

Al Amana targets both men and women and employs the group-liability loan model in rural areas. Similar to a group-based lending structure, each members of the group which is made up of 3 to 4 members, guarantee each other in the repayment of loan. The period of instalments can be weekly, twice a month or monthly. Each member receives a loan ranging from $124 to $1855. Additionally, they also provide individual housing loans, as well as non-agricultural businesses development. A higher loan up to $6000 are targeted at borrowers who are able to provide collateral with repayments made over a duration of 6 months to 7 years (Crépon et al., 2011). The tools for evaluation of loan application include cash flow analysis and business assessment.

The basis of its success is said to be in the effort put into training its staff, specifically the loan officers. Al Amana has a large number of loan officers assigned to do administrative work facilitating in higher productivity which enables it a cost per client of $55 (Mcphee & St-Onge, 2009). The main challenges faced by the institution lies in the mobilisation of funds, strategic planning as well as satisfying its borrowers and adjusting products to meet their needs.

Baitulmal Wat Tamweel (BMT), Indonesia. In order to reduce the level of poverty in Indonesia, the Center for Incubating Small Business (PINBUK) began promoting Islamic cooperatives under BMT in 1995, following the success of two pioneering BMTs in the 1980s and 1990s. BMT operates on an interest free-based system developed by influential religious figure of the society. Conceptually, BMT serves a dual role – as a Baitut Tamwil (house of financing) and as a Baitul Maal (house of wealth), which connotes its dual mission as a business and social entity. In order to fulfill its business mission, BMT plays its role as a financial intermediator which provides financial services particularly to small and micro enterprises (SMEs) by taking deposits. In serving its social mission, BMT acts as amil to collect and disburse zakah, infaq and sadaqah money as well as give loan on the basis of interest free financing to its clients. BMT adopts the concept of cooperative by using profit-loss sharing technique as well as group activities to mitigate risk.

Amanah Ikhtiar Malaysia (AIM), Malaysia. AIM was established in 1987 as the country's first NGO MFI which seeks to eradicate poverty and enhance the well-being of the low-income group in the country. As of March 2017, AIM has extended its outreach to 23 states in Malaysia with a total of 138 branches and is currently serving a total of 396,923 clients which are known as 'sahabat' (AIM, 2017). It adopts the group based Grameen Bank model, offering loans that are collateral free based on qard-hasan concept with a 10% of service charge.

Prior to becoming a sahabat, individuals are required to participate in a one week training programme to familiarise with the rules and procedures of financing and repayment. After passing the group recognition exam, the groups are then assembled into centers of two to twelve groups per center (AIM, 2017). Although financing is given on an individual basis, sahabats are required to be in a group of five acting as a support system for each other throughout the disbursement process following the joint liability group based lending. Repayment is based on collective responsibility guaranteed through mutual trust among members of each group which also involves pooling of funds to assist group members who are not able to meet their weekly repayment. AIM not only provides for financing but also a series of entrepreneurial development programs to cultivate appropriate entrepreneurship skill and knowledge required for the sahabats to properly make use of financing provided in order to succeed.

3. Challenges of Islamic microfinance

Outreach and Sustainability. The Islamic microfinance industry needs to establish an effective model to enhance outreach and sustainability in an effort to persuade Islamic banks to potentially invest in them. Innovation of microfinance models and products that comply with Shariah is essential to extend outreach for the growth of the industry. The limited range of diversified products and services offered accounts for low sustainability and market penetration. Although the existing models are fairly successful in fulfilling their purpose, they are still not able to fund for expenses incurred and continues to be dependent on subsidies and donor grants which in turn impedes further outreach. The main mode of financing adopted by most Islamic MFIs is the murabaha structure. The reason behind this is that Murabaha in its nature is not a profit-sharing structure which translates it to be a less complicated process and thus reduces the cost for its implementation. However, the mark-up price imposed tend to be higher than the conventional rates, thus, increasing the service cost of microcredit. Despite being the most ideal financing method, profit-loss sharing schemes do not gain as much popularity as those debt-based financing schemes.

Most MFIs, be it conventional or Islamic, are not economically viable due to lack of fund mobilization and high administrative costs. Their over reliance on grants are to the extent that some critics claimed that these institutions could not profit without receiving them. Islamic MFIs normally obtain funds from external sources apart from the seed capital given by governments, NGOs and volunteers. It is rather time consuming for Islamic MFIs to develop its financial viability as accumulated savings and profits can only be recycled into new loans after some time. It is noteworthy that there are yet to be explored sources of funds from Islamic institutions namely zakah, waqf and charity.

High Transaction Cost. There were reports of abuse of microfinance loans among clients which have led to stricter rules being imposed to address this issue (Abdul Rahman & Dean, 2013). Like their conventional counterpart, Islamic MFIs experience high transaction costs due to high disbursement, monitoring and collection repayments costs from their clients to reduce non-performing loans (NPL) and simultaneously generating profits to their shareholders as well as enhancing the social impacts of their services to clients. All of the aforementioned costs are directly related with the asymmetric information problems in the financial markets which would trigger moral hazard problem among clients where an individual who is protected against risk would act nonchalantly as opposed to his behaviour if he were fully exposed to risk.

4. Conclusion

In conclusion, the development of Islamic microfinance in recent decades has further proven the practicality of Islamic finance solutions. More importantly, they offer a unique proposition through alternative solutions in financial services provision for clients to adhere to Islamic principle. However, the sector faces a set of challenges similar to its conventional counterpart and also some that are distinctive to them. It can be deduced that the industry has vast room for improvement in terms of the business models employed. With experiences of other more established MFIs in the industry, Islamic MFIs have the added advantage of learning from them to avoid from incurring costly mistakes in their operations. Overall, the potential of the industry to expand and perform better is very high.

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